IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1923.

15

No. 447.

THE UNITED STATES, *Appellant*,

v.

THE SUPPLEE-BIDDLE HARDWARE COMPANY,

On Appeal from the Court of Claims.

BRIEF FOR APPELLEE.

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BRIEF FOR APPELLEE.

Statement.

On September 23, 1922, appellee filed its petition in the Court of Claims, praying for the recovery of $55,153.89, with interest, as taxes erroneously and illegally assessed and collected by the United States on the proceeds of a life insurance policy paid to it as a corporate beneficiary at the death in 1918 of its president (R., pp. 1-3). On May 7, 1923, the Court of Claims handed down its findings of facts (R., pp. 4-7) and opinion (R., pp. 7-9) and gave judgment for the plaintiff (appellee).

In its opinion, the Court held that the act of Congress (Revenue Act of 1918) by virtue of

which this tax was levied and collected, did not purport to tax the proceeds of life insurance policies; and, further, that the proceeds of life insurance do not constitute "income" within the scope of the definition of that term as laid down by this Court in *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509-518.

The United States has appealed from the judgment of the Court of Claims.

The Facts.

Appellee, the Supplee-Biddle Hardware Company, was the successor in business of two old established hardware firms in the city of Philadelphia (Finding I, p. 4). About January, 1914, they were merged and incorporated as the Supplee-Biddle Hardware Company and conducted business thenceforth as a single concern.

During February, 1917, Robert Biddle, 2nd, was elected president of the corporation, he being at that time thirty-seven years of age (Finding II, p. 4). He had gone to work with the Biddle Hardware Company at the age of eighteen and had held various offices previous to his being elected president of the merged company (Finding I, p. 4). He was "a man of ability, energy and initiative, and was so regarded in the hardware trade and by the banks with which the plaintiff dealt" (Finding III, p. 5).

In 1917, at the instance of the Board of Directors of the company, Robert Biddle, 2nd, took out two policies of insurance in the principal sum of $50,000 each, payable to the corporation in the event of his death. "These policies were taken out in good faith, the said Robert Biddle,

2nd, being a good moral risk and in perfect physical health. The policies were taken out for the purpose of providing a fund to make secure the financial position of the company in the event of the death of the said Robert Biddle, 2nd, and to indemnify the plaintiff against losses to its earning power which his death would occasion'' (Finding III, pp. 4-5).

In the Court's opinion (p. 7), Judge Hay says: ''It is admitted that Robert Biddle, 2nd, the president of the plaintiff company, was the managing head of the company; that he was a business man of ability, energy, and initiative, and by reason of his business ability and the confidence which he inspired in those with whom he came in contact in his business, he was a valuable asset to the plaintiff company. His activities in the business produced returns from the business which before his management of the company it had not earned. The death of such an executive head of the business would necessarily cause the company loss in income and in efficiency, and such loss and want of efficiency would continue until a president could be found who could take the place of the deceased president. It was the part of prudence in the plaintiff company to anticipate the possible loss which it might incur by insuring for its benefit the life of its president, and this it did by having Robert Biddle, 2nd, take out two life insurance policies amounting to $100,000 payable to the plaintiff company, and upon which the company paid the premiums. This action on the part of the plaintiff company was of the same character which causes prudent men to insure against loss by fire or against any

other casualty which may overtake men engaged in business.''

In 1918, when Robert Biddle, 2nd, was thirty-eight years of age, he contracted influenza and died. As the result of his death, the two insurance companies discharged the obligations of their policies; consequently, the appellee, after deducting premiums paid, received in the year 1918 as the net proceeds of the life insurance policies the sum of $97,947.28 (Finding IV, p. 5).

The company did not consider these proceeds as taxable income and therefore omitted them from the income reported as taxable for the year 1918; although to establish good faith, the company attached a memorandum to the return, disclosing that it had received this sum and its source for the information of the collector (Finding V, p. 5).

The Commissioner of Internal Revenue accordingly ordered a re-examination of appellee's return and included the proceeds of the insurance received to be included in income for 1918 and taxed (Finding VI, pp. 5-6).

The result was that appellee was forced to pay a tax of $84,737.95 on the proceeds, $97,-947.28, which it had received (Finding VII, p. 6).

The Commissioner of Internal Revenue, considering this enormous tax on the proceeds highly inequitable, reduced appellee's taxes by $29,-584.06, in accordance with the powers conferred upon him by Section 328 of the Revenue Act of 1918 to reduce the rate of taxation in cases of unusual hardship (Finding IX, p. 6).

There remained the sum of $55,153.89, however, which represented taxes which appellee had

paid solely because of the inclusion of these insurance proceeds in income (Finding X, p. 6) and for this sum, together with interest from the time the tax was paid under protest, the Court of Claims gave judgment (Conclusion of Law, p. 7).

The Questions Involved.

Under the facts found in this record, the questions presented to this Court are:

A. Are the proceeds of life insurance policies when paid to a corporation beneficiary, upon the death of an officer which it has insured for its benefit, taxable as income to it?

1. Are the proceeds of life insurance policies "income" within the meaning of that term as used in the Sixteenth Amendment to the Constitution of the United States?

2. Does the Revenue Act of 1918 (Act of Feb. 24, 1919, 40 Stat. 1057, c. 18), when properly construed, tax the proceeds of life insurance policies as "income"?

In discussing the above questions, we will begin with the question of the proper construction of the Revenue Act of 1918, in order to acquaint the Court with the act, the history of income tax legislation, and the construction placed upon it by the Treasury Department; although the constitutional question involved is the more im-

portant because of the fact that taxpayers quite generally believe that the proceeds of life insurance are not income within the Constitutional sense. The case is one of first impression for the industry of counsel has failed to disclose a case directly in point or in fact any case where the essential nature of life insurance proceeds has been considered in connection with the income tax laws, or the constitution.

I.

The proceeds of life insurance are not within the definition of gross income as found in Section 213 of the Revenue Act of 1918 and such proceeds are not taxable under said Act.

In considering the proper construction of the Revenue Act of 1918, the plan of the act should first of all be noticed. The net income which is the subject of the tax is arrived at by defining "gross income" and subtracting therefrom certain specified deductions. In defining gross income, Congress specified what it should include and what it should not include.

Congress further divided the act into two parts; one dealing with individuals and the other with corporations.

Gross income for individuals is defined in Section 213 of the Act, from which can be taken the deductions authorized in Section 214.

Gross income for corporations incorporates by reference the definition of gross income as set out in Sec. 213 (for individuals), and from that certain deductions set out may be taken by corporations. This explanation is only important so

far as it bears upon the interpretation to be given the word "individual", which appears in paragraph b-1 of Sec. 213, relating to individuals.

Section 213, so far as it is pertinent, reads as follows:

That for the purposes of this title * * * the term "gross income"

> "(a) includes gains, profits and income derived from salaries, wages or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits *and* income derived from any source whatever * * *; but
>
> (b) does not include the following items, which shall be exempt from taxation under this title:
>
> (1) The proceeds of life insurance policies paid upon the death of the insured to *individual* beneficiaries or to the estate of the insured." (Italics ours.)

In the remainder of the statute having to do with the tax on corporations, no mention is made of the proceeds of life insurance policies, so that nowhere in the statute is there any language used directly taxing such proceeds.

Nevertheless, the Treasury Department in construing this statute, held that the proceeds of insurance policies paid to a corporation beneficiary were taxable and issued regulations in

accordance with that view. Regulations 45, Art. 541. The conclusion of the Treasury was obviously arrived at because of the exemption of the proceeds of life insurance policies paid to *individuals* and *estates* as provided for in paragraph (b), the proviso, and thereby construing by *implication* that paragraph (a) the enacting clause, taxes the proceeds of all life insurance policies, notwithstanding that such proceeds are not mentioned or even approximately described in paragraph (a).

Nothing is better settled than that a taxing statute is not to be construed as levying a tax by implication. In *Gould* v. *Gould*, 245 U. S. 151, Mr. Justice McReynolds said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations *so as to embrace matters not specifically pointed out*. In case of doubt they are construed most strongly against the government, and in favor of the citizen. *United States* v. *Wigglesworth*, 2 Story, 369, Fed. Cas. No. 16,690; *American Net & Twine Co.* v. *Worthington*, 141 U. S. 468, 474; *Benzinger* v. *United States*, 192 U. S. 38, 55." (Italics ours.)

The Treasury regulation attempts to construe paragraph (a), the enacting clause, as *embracing matters not specifically pointed* out solely because of the implication in paragraph (b), the proviso.

It will be noted that the proceeds of life insurance policies are not within the scope, even remotely, of the descriptive words used in paragraph (a), the enacting clause. They are cer-

tainly not "gains, profits and income derived from salaries, wages or compensation for personal service", nor from professions nor from business transactions carried on for gain or profit. The only phrase in paragraph (a) which could possibly be used as a peg upon which to hang this tax would be the phrase at the conclusion of the definition, "or gains or profits and income derived from any source whatever." Nor does the government point out any language in paragraph (a) descriptive of life insurance proceeds.

Under the ordinary rules of statutory construction, however, this phrase would be construed as inclusive of the objects selected for the tax by the legislature, and under the doctrine of *ejusdem generis* would not be expanded to include matters other than those which the legislature or Congress had undertaken to specify. As was pointed out, in construing similar provisions of the 1913 Act (38 Stat. 114, 166, c. 16) in *Gould* v. *Gould* 245 U. S. 151:

> "The use of the word itself in the definition of 'income' causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed."

It is our purpose to point out in the second part of this brief that life insurance proceeds are not comprehended in the definition of income as applied to the Sixteenth Amendment, but it is sufficient for our present purpose to call attention to the fact that Congress is not obliged to use the word income as taxing everything that might

be taxed under the Constitution; and, therefore, there can be no presumption that because of the use of the word "individual" in paragraph (b), the proviso, that there was any intent to tax more than the descriptive words in paragraph (a), the enacting clause, fairly imply. In *Towne* v. *Eisner*, 245 U. S. 418, Mr. Justice Holmes said:

> "But it is not necessarily true that income means the same thing in the Constitution and the Act. A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used. *Lamar* v. *United States*, 240 U. S. 60."

In that case the question was whether stock dividends were taxable under the 1913 Act, where stock dividends as such were not mentioned in the Act, and the Act was construed as not taxing stock dividends, although the phrase "income derived from any source whatever" appeared in that Act. This Court subsequently disagreed as to how far the decision in that case went (*Eisner* v. *Macomber*, 252 U. S. 189), but we have no doubt that it is authority for the point on which we cite it.

The words used in paragraph (a), the enacting clause, are general ones and words in popular use. To the ordinary citizen they would imply gains or profits made in ordinary business transactions, either through employment, barter or investment. They would not be thought as embracing matters which are not usually thought of as business transactions. Congress was willing to post its pickets some distance from the

constitutional frontier and the language used would ordinarily be so understood.

As a matter of fact, to construe the section as taxing the proceeds of insurance casts upon Congress an intent to regard such proceeds as both capital and income, an anomaly which, unless avoided, is fraught with serious dangers to the taxing statutes. Under the Estate Tax Law enacted at the same time (Act of Feb. 24, 1919, C. 18, Sec. 401), Congress by Sec. 402 thereof has expressly included in the gross estate of the decedent the proceeds of life insurance policies received by the executor which the deceased had taken out on his own life, and also the proceeds received by all other beneficiaries, subject to an exemption of $40,000. If such proceeds are subject to the estate tax, it must be that Congress considered them as equivalent to an asset passing at the time of death. If such proceeds are income as the Treasury holds, and taxable as such, except for the beneficent exemption allowed by Congress, how can they at the same time be part of the corpus of the estate of a decedent? The theory of the estate tax is that Congress has the power to tax the transfer of the estate. *Knowlton* v. *Moore*, 178 U. S. 41. The estate is considered as property, *i. e.*, capital, and cannot be taxed as such without encountering the prohibition against direct taxes. Congress, therefore, regarded such proceeds as a part of the corpus of the estate passing at the time of death. Such proceeds were in the nature of a devise or bequest which Congress directed in Sec. 213 (b) (3) should not be included in income.

But without attempting to reconcile these divergent concepts of the nature of insurance

proceeds for the time being, our point is that by *expressly* taxing such proceeds as part of a decedent's estate and not as income to it, it is a clear indication that Congress did not intend to include such proceeds in the purview of Section 213 (a) *supra* as "income."

And, furthermore, the provisions of the Estate Tax Law clearly explain the purpose of Section 213 (b), the proviso, in exempting such proceeds to individuals and estates in order to guard against any interpretation of Sec. 213 (a), the enacting clause, which would result in double taxation or invalidate its expressed intention of including such proceeds in the gross estate of a decedent and taxable upon the transfer of that estate by reason of death. Corporations are not ordinarily beneficiaries of an estate, and are not as a rule beneficiaries of life insurance policies which might be taken out to avoid the estate tax. As a means of avoiding the estate tax the resort to insurance is obvious. Consequently, the omission of the word "corporation" is better explainable as an oversight than any implied construction of Sec. 213 (a). Sec. 402 of the Estate Tax Law of 1918 provided that there should be included in the "gross estate":

> "And to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

There is, therefore, no distinction in the Estate Tax Law between the beneficiaries, whether individual, corporate or the estate, so that if the Commissioner of Internal Revenue is right the

proceeds of insurance payable to a corporation beneficiary would be subject to both income and estate taxes, a construction of the entire act which should be avoided if there is any other reasonable interpretation. And this notwithstanding that the value of property acquired by "gift, bequest, devise or descent", is excluded from Sec. 213 (a) by Sec. 213 (b) (3).

It is argued by the government that the history of income tax legislation is in accordance with the Treasury interpretation of this law with respect to these proceeds. But with this argument we disagree.

Beginning in 1861 and ending in 1894, a series of ten income tax acts were passed, the last one meeting with the fate of being declared unconstitutional (*Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601); although this court had previously apparently sustained the constitutionality of a similar act of 1865. *Springer* v. *U. S.*, 102 U. S. 586. These acts were the following[1]:

Act of Aug. 5, 1861, 12 Stat. 292-313.
Act of July 1, 1862, 12 Stat. 432-489.
Act of March 3, 1863, 12 Stat. 713-731.
Act of June 30, 1864, 13 Stat. 223.
Act of March 3, 1865, 13 Stat. 469.
Act of March 10, 1866, 14 Stat. 4-5.
Act of July 13, 1866, 14 Stat. 98-173.
Act of March 2, 1867, 14 Stat. 471-487.
Act of July 14, 1870, 16 Stat. 256-262.
Act of Aug. 15, 1894, 28 Stat. 553-69.

In referring to these acts we can trace the general evolution of the definitions finally ap-

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1 These early acts, together with subsequent income tax laws, are collected in Federal Income Tax Laws, Barton & Browning (John Byrne & Co., Washington).

pearing in Sec. 213 (a). The Act of Aug. 5, 1861, for example, provides:

> "That from and after the first day of January next, there shall be levied, collected, and paid, upon the *annual income* of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, *or from any source whatever,* if such annual income exceeds the sum of eight hundred dollars, a tax, etc. * * * (Italics ours.)

At this point we wish to interpolate our argument for the purpose of calling attention to the fact that the phrase "income—from any source whatever," which, as we have said, appears to us to be the only phrase which could possibly be expanded to include the proceeds of life insurance policies, appears in the first act and was evidently intended as a declaration that the source of the income, even if it were land, for example, would not subject it to exemption from the tax. It was an attempt to avoid the Constitutional limitations against a direct tax and not for the purpose of enlarging the scope of the subject matter described. This is apparent in the first act, where the word "income" is separated from the rest of the phrase concerning the source. It was later decided in the *Pollock* case (158 U. S. 601) cited *supra,* that income could not be taxed regardless of source, and the result of it all was the language finally employed in the Sixteenth Amendment. The obvious purpose was to tax income from trade, employment or property, without regard to the source being prop-

erty, for instance, but not to tax income from any other source than those mentioned.

To return to the acts cited above, however, it will be found that the sections defining income are enlarged until they are in substantially the same form as Sec. 213 (a) of the 1918 Act. And yet in none of these acts is there any mention made of the proceeds of life insurance policies, nor any attempt to tax such proceeds directly or indirectly. These Acts originated during the Civil War when the need for money was as acute as during the World War, and the desire to obtain money by taxation just as extreme; but, whereas the terms used in the definition of what was to be taxable as income were constantly increasing from year to year, no attempt was made to tax the proceeds of insurance.

Under these acts the only reference to the subject of insurance proceeds is an instruction issued by the Commissioner of Internal Revenue advising collectors that insurance proceeds were not taxable as income. This was a Treasury decision of March 9, 1867, which is reported in the Internal Revenue *Record* (N. Y.) issue of April 6, 1867. This publication is to be found in the Congressional Library, but we have been unable to find any official reports of that period, although it is referred to in Treasury *Digests*. The ruling was a construction of the Act of 1867, which provided:

> "That there shall be levied, collected, and paid annually upon the gains, profits, and income of every person residing in the United States, or of any citizen of the United States residing abroad, whether derived from any

> kind of property, rents, interest, dividends or salaries, or from any profession, trade, employment or vocation, carried on in the United States or elsewhere, or from any source whatever, a tax, etc."

So far as our investigation has gone this ruling applied as to all the income tax laws, and apparently in its research the Government has not discovered any contrary ruling, so that up until the time of the adoption of the Sixteenth Amendment these acts, by long, continued interpretation by the Treasury Department, have been construed as not taxing the proceeds of insurance. This construction is entitled to great weight.

> *Kern River Co.* v. *U. S.*, 257 U. S. 147-154.
>
> *Grand Trunk Western R. Co.* v. *U. S.*, 252 U. S. 112-121.
>
> *U. S.* v. *Alabama G. S. R. Co.*, 142 U. S. 615.

Following these acts no further income tax laws were passed, except the Corporation Excise Tax Law, which measured the tax by the income of the corporation (Act of August 5, 1909, 36 Stat. 113-18, C. 6), until after the adoption of the Sixteenth Amendment. This act applied specifically to corporations and no attempt was made by its terms to tax life insurance proceeds.

As this Court has often decided, the effect of the Sixteenth Amendment was not to enlarge the definition of income, but simply to remove the constitutional objection to the taxing of income from a source which itself could not be taxed

under the Constitution. In *Peck* v. *Lowe*, 247 U. S. 165-172, the Court said:

> "As pointed out in recent decisions, it (the 16th Amendment) does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the states of taxes laid on income, whether it be derived from one source or another."

We have, therefore, at the time of the adoption of the Sixteenth Amendment, a settled construction that language of practically the same import as that used in Section 213 (a), the enacting clause, of the Act of 1918, did not comprehend the inclusion of the proceeds of life insurance in the term "income." And what the word meant at the time of the adoption of the Sixteenth Amendment is the constitutional frontier beyond which Congress may not go. *Eisner* v. *Macomber*, 252 U. S. 189; *Merchants Loan etc.* v. *Smietanka*, 255 U. S. 509-518-519.

When we reach the constitutional question we will argue that the fixed construction of these acts excludes the proceeds of life insurance policies from the definition or conception of income at the time of the adoption of the Sixteenth Amendment. For the present we are content to urge that the settled construction of the language employed in the former acts is persuasive of the proper construction of Sec. 213 (a) of the Act of 1918. The statutes being in *pari materia* and further the evolution of a taxing scheme, the construction of the language in the earlier statutes should settle the construction to be placed on the later statutes.

It is only after the adoption of the Sixteenth Amendment that we find any reference to the proceeds of life insurance policies, and then only as deductions from the gross income defined in general terms in the enacting clause. The general definition of income is, with minor modifications, of the same purport in the following acts passed since the amendment.

Sec. B-1, Act of October 3, 1913 (38 Stat. 166-81, C. 16).
Sec. 2(a), Act of Sept. 8, 1916 (39 Stat. 756-7, C. 463).
Sec. 1200 (1) Act of Oct. 3, 1917 (40 Stat. 300-38, C. 63).
Sec. 213(a) Act of Feb. 24, 1919, (*re* Stat. 1057-96, C. 18), known as the 1918 Act.
Sec. 213 (a) Act of Nov. 23, 1921 (42 Stat. 227-321, C. 136).

The 1913 Act provided that the proceeds of life insurance policies *should not be included as income.* No mention was made in this act of any exemption, a word loosely used in the subsequent acts, as for example the "exemption" of "interest on the obligation of any state" in the 1917 Act.

The acts of 1916 and 1917 "exempted" the proceeds of insurance policies paid to individual beneficiaries, and the 1918 Act extended the exemption to estates. These acts also "exempted" the income from state obligations, which were obviously not taxable income, and also property acquired by gift, bequest, devise, or descent. It seems obvious that Congress would not have the

power to levy a direct tax on legacies by virtue of any power given it to levy income taxes; and, therefore, the use of the term "exempt" seems inapt, for a taxpayer could demand the exclusion of a devise or bequest from taxable income by way of right and not by grace of Congress.

The 1921 Act exempted the proceeds of insurance paid upon the death of the insured. Ordinarily a change made in a subsequent act of Congress may have little weight as a legislative construction of a former act, as is pointed out in the government brief, but this change we assert has weight because of the ambiguity in the 1916, 1917 and 1918 acts, and because of the fact that the construction of the Treasury was at odds with the settled policy of Congress. The facts in this case show the length of time it would take for the Treasury Department to make a determination of any given case, the tax on the life insurance proceeds in this case having been exacted on January 8, 1921, almost two years after the return was due and less than a year before Congress passed the 1921 Act, so that it is reasonable to suppose that Congress at the first opportunity hastened to correct an erroneous construction.

Consequently, we reiterate that the history of income tax legislation in the United States shows without question that language of the general import of that used in Sec. 213 (a) was never thought to include the proceeds of life insurance policies, and when the Treasury Department departed from long continued construction, Congress, at the first opportunity, corrected that interpretation.

It is said in the government brief that appellee is trying to bring itself within an exemption to the tax imposed by the act and that therefore the burden is upon appellee to establish the exemption. But this argument is an attempt to turn the coat inside out. The question involved is the proper construction of Sec. 213 (a)—whether life insurance proceeds are taxed by the general language of that section. The burden is on the government to show that this section embraces matters not specifically pointed out. *Gould* v. *Gould*, 245 U. S. 151. It, in effect, tries to do so by assuming that there is an *implication* of the proper construction in Section 213 (b) (1). Our reply is that you cannot construe a statute as levying a tax by implication. Appellee is not trying to bring itself within any exemption granted by paragraph (b) (1). If paragraph (a), the enacting clause, can be construed as taxing life insurance proceeds, appellee has no disposition to argue that it is exempt from that tax because of the language of paragraph (b) (1). Its contention is simply that the scope of paragraph (a) cannot be enlarged by any implication contained in paragraph (b). Without that implication, as has been shown, by considering the income tax legislation historically and also by considering it in relation to other taxing acts in *pari materia*, it is not susceptible of the construction placed on it by the Treasury.

By a fair construction we think that the intent of paragraph (b) was not to grant exemptions, but declaratory of items which were not to be included in income because they were not income under any consideration. If paragraph (b) has

the force which the Treasury gives it, then Congress has included in paragraph (a), except for its grace in granting an exemption, interest on municipal bonds, interest on Federal obligations which were issued as tax exempt, the return of insurance premiums, the value of property acquired by gift, devise or descent and the proceeds of life insurance policies. Certainly to construe Section 213 (a) as taxing the income of municipal bonds in the absence of the exemption would be to impute an absolutely unwarranted construction of the section and we believe that this Court would require a definite statement of this intent in Sec. 213 (a) before it would construe the section as taxing such income and pass on to the constitutional question involved. The test of the Treasury construction is, would Section 213 (a) standing alone be thought as including the interest on municipal bonds in gross income in view of the almost universal opinion that such interest cannot be taxed under the Constitution? If not, whatever is said in paragraph (b) cannot be said to imply what is taxed by paragraph (a).

In discussing the constitutional question we will analyze the legal and popular conception of life insurance proceeds, which will, of course, be as applicable to the language employed in Sec. 213 (a) as it will to the constitutional conception of income.

II.

Life Insurance Proceeds are not "Income" within the meaning of the Sixteenth Amendment and are therefore not taxable.

As a result of *Pollock* v. *Farmers' Loan & Trust Company*, 158 U. S. 601, the Sixteenth Amendment to the Constitution was adopted in 1913. It reads as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

Its purpose was not to extend the taxing power of Congress to any new or generic field, but the "prevention of the resort to sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself."

Brushaber v. *Union Pacific Railway Co.*, 240 U. S.-1-19.
Peck v. *Lowe*, 247 U. S. 165-172.
Evans v. *Gore*, 253 U. S. 245-260.

The rule then by which this amendment is construed is the same as the ordinary rule of constitutional construction; namely, that the language is to be given the meaning it had at the time of the adoption of the amendment. What it meant then it continues to mean, and Congress may not, by any definition it adopts, extend the power granted to any new field not comprehended by the term "income" at the time this amendment was adopted.

Gibbons v. *Ogden*, 9 Wheat 1.
McCullough v. *Maryland*, 4 Wheat, 316.
Eisner v. *Macomber*, 252 U. S. 189.

The definition adopted by this Court of "income" in its constitutional sense is:

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."
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> *Gray* v. *Darlington*, 15 Wall. 63.
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> *Stratton's Independence* v. *Howbert*, 231 U. S. 399-415.
>
> *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179.
>
> *Eisner* v. *Macomber*, 252 U. S. 189-207.
>
> *Merchant's Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509-518.

A word as to the evolution of this definition may not be out of place. Under the earlier acts only annual income was taxed, so that a profit on the conversion of property held some years was held not taxable in *Gray* v. *Darlington*, 15 Wall 63. Where the entire income was taxed in the year it was received, whenever it accrued, it was held that there was no objection to the tax on the profit. *Doyle* v. *Mitchell Bros.*, 247 U. S. 179. This accounts for the proviso to the definition. The definition itself was evolved in *Stratton's Independence* v. *Howbert*, 231 U. S. 399-415, where this court held that the income received from a mine was taxable notwithstanding the mine was depleted to the extent of the minerals taken out in any one year, on the ground that capital and labor were required to extract the mineral and make it marketable. Therefore, profits on the sale of the ore was not

a mere exchange of capital, but the receipt of income.

This definition is further elucidated in *Eisner* v. *Macomber*, 252 U. S. 189, 207, where it is said:

> "Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. '*Derived-from-capital*'; '*the gain-derived-from-capital*,' etc. Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*'—that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description."

Do the proceeds of life insurance policies fit into this definition? Are they the gain received from capital, a profit *derived* from capital? The government answers in the affirmative and says that the insured invests money in the form of premiums in an insurance policy—this is the capital—and from that capital the proceeds are *derived* which are profit. One would have to be steeped indeed in the modern science of accounting not to detect a false ring to this argument.

Take the ordinary policy of insurance where the husband insures his life and names his wife

the beneficiary of the policy. Invariably he pays the premiums, invests the capital. She does nothing but collect the proceeds. Is she the recipient of a gift? She has invested nothing. There has been no outlay of capital upon her part. She has gained, in the sense of having a sum of money in lieu of her husand, but the gain was *derived* neither from capital nor labor. The government's logic falls at once unless the beneficiary pays the premiums. If Robert Biddle, 2nd, had paid the premiums on the insurance policies in the present case, would the company have gained anything from the investment of capital? Obviously not. And yet the essence of the proceeds would have been the same and the government would have made no distinction, as in either case the Treasury Department held the proceeds to be taxable.

Taking issue with the government directly, we deny that premiums paid are an investment of capital from which is *derived* a gain or profit. The case at bar is a striking illustration that a fallacy lurks in such reasoning. If upon an investment of $2,126.50 a profit of $97,947.28 could be made in one year, all of the money in the country would at once be poured into the insurance companies as premiums. This, of course, is simply pointed out as a test of the reasonableness of the government's theory on the face of it.

As a matter of fact, the reason why the government's theory is wrong is that the premiums paid by any individual policy holder to an insurance company bear no relation whatever to the proceeds paid to the beneficiary, except in the aggregate. In the simplest form of insurance, a group of persons associate themselves

together for protection against loss or casualty. If it is to insure against loss of property, it is known in advance that some of the group but not all will suffer such loss. From actuarial experience, the approximate amount of that loss is known, as well as the amount of the loss for each year. From this knowledge it is simply a matter of calculating how much each person must pay into the fund, which with the interest it will earn, less deductions for losses, will cover the anticipated losses. In life insurance, the only difference is that a specified amount is fixed to be paid upon the death of any of the subscribers. Insurance becomes more complicated, of course, as new members are taken in, and annual or "level" premiums are substituted for the "single premium" (paid in advance) or the "natural premium" paid concurrently with the casualty, and the load is added for overhead, etc., and the minor adjustments which must be made to adjust the premiums to necessary reserves instead of the estimated ones based on the actuary's forecast, but in principle, it is the same as the simpler form.

> *Penn Mutual Co. v. Lederer*, 252 U. S. 531-2.
>
> *Principles of Insurance*, W. F. Gephart, Vol. I, p. 258.
>
> *Life Insurance*, Solomon S. Huebner, pp. 9, 258; Chap. XV.

As was said by Justice Bradley in *N. Y. Life Insurance Co. v. Statham*, 93 U. S. 24 (23 L. Ed. 789-791):

"The insured parties are associates in a great scheme. This associated relation ex-

ists whether the company be mutual or not. Each is interested in the engagements of all; for out of the co-existence of many risks arises the law of average, which underlies the whole business."

It is apparent, therefore, that the proceeds issue from the capital supplied by the group and not by the individual. But the group as a group comes out just where it started for otherwise insurance companies could not exist. The group gets back the money it put into the venture and there is no profit or no gain; it is simply a return of the capital. The individuals share that return of capital in different proportions according to their original agreement, to be paid a given sum upon the happening of some casualty. Nothing is returned to the individuals fortunate enough to escape the dreaded casualty; while the stipulated amount is paid the sufferer. And the sufferers differ in their participation of the fund, for on the single premium plan, for instance, one may be out of the use of his money for many years while the other may suffer the casualty and be reimbursed within a short time, and on the annual premium plan, few or many premiums may be paid. The same thing is true of life insurance.

From this analysis, it seems clear that the proceeds of life insurance or any other kind of insurance, do not constitute profit derived from premiums. If there is any profit at all on the premiums, it is the interest which the insurance company is able to earn on the premiums, which is added to the reserve against the policy. That, of course, would be an entirely different sum

than the proceeds of the policy paid upon death or any other contingency, and would vary according to the length of time premiums had been paid in. *Cf. Penn Mutual Co.* v. *Lederer,* 252 U. S. 531-2 and cases cited. And in the case of annual premiums, the point at which a given individual of longevity passed the point where such interest becomes diminished because of earlier casualties would be of such nicety as to escape computation.

In testing the accuracy of the government's theory, we see no difference between life insurance and casualty, fire or marine insurance. In each form of insurance, premiums are paid, and if the government is correct, the proceeds issue from the premiums. And yet we venture to say that the government would not assert that insurance recovered for the loss of a ship would be income. But there is no distinction so far as the relationship between premiums and proceeds goes, and we therefore confidently say that the proceeds of insurance policies do not constitute gain or profit *derived* from the premiums as capital investment. The proceeds are *derived* from the *entire* capital supplied by the group; what the policy holder gets is compensation for a loss. And therefore, such proceeds are not contemplated within the definition of income as adopted by this court.

Our position is that the true essence or nature of insurance proceeds is indemnity for a loss sustained, and is not profit or gain in any sense. This is illustrated by the doctrine of insurable interest. Without insurable interest, the insurance contract is against public policy and cannot

be enforced. In marine and casualty insurance of all descriptions, the insurable interest must be a pecuniary interest in the property insured, in order to support the policy; and this in turn means that the contract is one merely of indemnity for the thing lost. In *The Phoenix Mutual Life Insurance Co.* v. *Bailey*, 13 Wall. (80 U. S.) 616-623, it is said:

> "Marine and fire policies are contracts of indemnity, by which the claim of the insured is commensurate with the damages he sustained by the loss of, or injury to, the property insured."

After wagering contracts were forbidden by statute, the courts came to look on insurable interest wholly as a pecuniary interest, but the subsequent development of life insurance brought a new problem, which caused an expansion of the conception of insurable interest because individuals often had no pecuniary interest in the assured as such, but were bound to him solely by consanguinity or affection. The doctrine as expended is described in *Connecticut Mutual Life Ins. Co.* v. *Schaeffer*, 94 U. S. 457-463:

> "It will be proper, in the first place, to ascertain what is an insurable interest. It is generally agreed that mere wager policies, that is, policies in which the insured party has no interest whatever in the matter insured, but only an interest in its loss or destruction, are void, as against public policy. This was the law of England prior to the Revolution of 1688. But after that period, a course of decisions grew up sustaining wager policies. The Legislature finally interposed, and prohibited such insurance; first, with regard to marine risks, by Statute of 19 Geo. II., ch. 37; and next, with

regard to lives, by the Statute of 14 Geo. III., ch. 48. In this country, statutes to the same effect have been passed in some of the States; but where they have not been, in most cases either the English statutes have been considered as operative, or the older common law has been followed. But precisely what interest is necessary, in order to take a policy out of the category of mere wager, has been the subject of much discussion. In marine and fire insurance the difficulty is not so great, because there insurance is considered as strictly an indemnity. But in life insurance the loss can seldom be measured by pecuniary values. Still, an interest of some sort in the insured life must exist. A man cannot take out insurance on the life of a total stranger, nor on that of one who is not so connected with him as to make the continuance of the life a matter of some real interest to him."

But regardless of the fact that the interest may be one of consanguinity or affection, nevertheless, the contract is one of indemnity in its essence and the proceeds received are indemnity. This is pointed out in *Central Bank of Washington v. Hume*, 128 U. S. 195:

"Marine and fire insurance is considered as strictly an indemnity; but while this is not so as to life insurance, which is simply a contract, *so far as the company is concerned*, to pay a certain sum of money upon the occurrence of an event which is sure at some time to happen, in consideration of the payment of the premiums as stipulated, *nevertheless the contract is also a contract of indemnity*." (Italics ours.)

The dual character of life insurance policies is again pointed out in *The Phoenix Mutual Life*

Insurance Co. v. *Bailey,* 13 Wall 616, where it is said that the "contract of life insurance is not necessarily one merely of indemnity for a pecuniary loss" but the policy is valid if it appears "that the beneficiary had an interest, whether pecuniary or arising from dependence or natural affection, in the life of the person insured."

We can here part company with ordinary life insurance where the insurable interest is consanguinity or affection, for a corporation beneficiary of the proceeds of a life insurance policy paid upon the death of the officer must necessarily have a pecuniary interest—else the policy would be void. But before doing so, it can be pointed out that from the standpoint of the beneficiary, the loss is none the less real because of the fact that a human life is difficult of estimation. To the average widow, the proceeds come as an indemnity and a very inadequate one for the loss of the husband. The proceeds constitute a fund, in popular conception at least, which takes the place in a small measure of the earning capacity of the husband. And the cases where the proceeds would be regarded as a clear gain are so few as to make them inconsequential in viewing the whole field. Congress may have had this motion in mind, however, in exempting proceeds paid to *individual* beneficiary, meaning thereby, *that not even in the case of individual beneficiaries* should the proceeds be included in gross income.

But whatever is the fate of proceeds received by widows and orphans, shocking though it may be to conceive them income, it is clear upon analysis that a life insurance policy upon the

life of a corporate officer, the corporation being the beneficiary, *must be a contract of indemnity.* Insurance on the life of a corporate officer was sustained on earlier decisions holding that a creditor had an insurable interest in the life of his debtor to the extent of the debt and that the contract was one of indemnity. These cases are reviewed in *Crotty* v. *Union Mutual Life Ins. Co.*, 144 U. S. 621, where Mr. Justice Brewer said:

> "Without noticing other questions discussed by counsel, it is sufficient to consider that of plaintiff's interest in the policy. It is the settled law of this court that a claimant under a life insurance policy must have an insurable interest in the life of the insured. Wagering contracts in insurance have been repeatedly denounced. *Cammack* v. *Lewis*, 82 U. S. 15, Wall, 643 (21:244), in which a policy of $3,000, taken out to secure a debt of $70, was declared 'a sheer wagering policy.' *Connecticut Mut. L. Ins. Co.* v. *Schaefer*, 94 U. S. 457, 461 (24:251, 253) in which it was said: 'In cases where the insurance is effected merely by way of indemnity, as where a creditor insures the life of his debtor, for the purpose of securing his debt, the amount of insurable interest is the amount of the debt.' *Warnock* v. *Davis*, 104 U. S. 775 (26:924).
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> * * * *
>
> If a policy of insurance be taken out by a debtor on his own life, naming a creditor as beneficiary, or with a subsequent assignment to a creditor, the general doctrine is that on payment of the debt the creditor loses all interest therein, and the policy becomes one for the benefit of the insured and collectible by his executors or administrators. In 2 May, *Ins.* (3d ed.) 459a, the author says: 'A creditor's claim upon the proceeds of in-

surance intended to secure the debt should go no further than indemnity, and all beyond the debt, premiums and expenses, should go to the debtor and his representatives, or remain with the company, according as the insurance is upon life or on property.' *Central Bank of Washington* v. *Hume*, 128 U. S. 195, 205 (32:370, 375)."

The courts have accordingly sustained such policies and have held that there is a real and pecuniary interest which the corporation has in the life of an officer, just as much of an interest as it has in any physical asset, and the policy is sustainable on the ground that it is an indemnity against the loss of that asset, intangible though it may be.

A case illustrating the transition from the debtor-creditor policy to the officer-corporation policy, is *Mechanics National Bank* v. *Comins*, 72 N. H. 12, 55 Atl. 191, where it is said:

> "It is hardly necessary to say that the success of a corporate enterprise may be so interwoven with the personality of its manager that its stock is taken, and money is loaned to carry it on, as much in reliance upon that personality as upon the intrinsic merit of the enterprise; and no good reason appears why a stockholder or creditor, the value of whose investment may be reasonably said to depend upon the life or health of the man at the helm, should not have an insurable interest in his life, the same as one who invests money in a partnership, relying upon the skill or experience of his copartner, has an insurable interest in the life of the latter, or one who equips a mining expedition has an insurable interest in the life of him to whom its management is committed. The

creditor or stockholder, under such circumstances, would seem to have that 'reasonable expectation of pecuniary benefit or profit from the continuance of another's life' which is held sufficient to constitute an insurable interest. In such case 'the essential thing * * * that the policy should be obtained in good faith, and not for the purpose of speculating upon the hazards of life' would appear to be present."

The leading case on the subject, which also further illustrates that the proceeds are compensation for a loss, is *Mutual Life Insurance Co. of New York v. Board, Armstrong and Company*, 115 Va. 836, 80 S. E. 565. The court there said:

"We are further of the opinion that this contract of insurance effected by the plaintiff was not an *ultra vires* act on its part and that the 'loss of service in the event of death' as stated in the policy, was a sufficient interest to maintain the policy in favor of the beneficiary * * * The deceased was the president and manager of the corporation, and had been since its organization. His relation to and knowledge of the financial and manufacturing interests of the plaintiff was such that his death could not fail to result in serious and substantial loss to its creditors and all others interested in its prosperity. Although it is well known that the leading insurance companies of the country solicit and carry the class of insurance herein involved, we have been unable to find any decision directly in point. The principles, however, announced by the decision and stated by the text writers we think clearly show that the plaintiff had an insurable interest in the life of B. F. Board, its president and general manager."

This is also the law of Pennsylvania: *U. S. Life Ins. Co. of Pa.* v. *Brown*, 270 Pa. 270, 113 Atl. 446:

> "The question of insurable interest of the employer in the life of the employee, or of the corporation in the life of its officers, though not the subject of discussion in Pennsylvania, has been considered in other jurisdictions where it is held that there is no implied interest in the life of such persons justifying the issuance of a policy for the benefit of the employer. (Citing *Victor* v. *Louisa Cotton Mills*, 148 N. C. 107; 61 S. E. 648.)
>
> To sustain a contract of this character, it must further appear that there is a real concern in the life of the party named, whose death would be the cause of *substantial loss* to those who are named as beneficiaries. This does not follow the cessation of ordinary service, but arises where the success of the business is dependent on the continued life of the employee." (Italics ours.)

These cases show conclusively that except for the monetary interest which the corporation has in the life of an officer, the contract of insurance would be illegal and void as against public policy. If that is true, the corporation suffers a loss upon the death of the officer and the insurance proceeds are nothing more than indemnity or compensation for that loss. This takes the proceeds out of the conception of "income" and places them in the category of a return of capital. If a man receives insurance for the value of a house destroyed by fire, he has gained nothing nor has he profited; he has received the equivalent in value of the thing he lost as compensation for

the loss and he is no richer than he was before. He has not received income. And the same thing is true where a corporation loses the service of an officer by death. The corporation has lost a valuable asset, an income-producing factor, and if it has provided against the possibility of that loss by insurance, the proceeds represent the loss and are not income. The proceeds become the income-producing factor.

It seems to us that the government becomes confused in its attempt to determine what is income and what is not income by reference to so-called accounting principles. One of the reasons for the complexity of income tax regulations is the attempt of the Treasury to squeeze the law into the system of balances idealized by accountants. The attempt is to fit the law to accounting, rather than accounting to the law.

The government seeks to argue that life insurance proceeds are not compensation for a loss on the ground that the officer could not be set up on the books as an asset. But if we call things by their right names instead of by the so-called technical terms of accountants, the personality and value of officers *are* set up on the books of most corporations. Only the account is called *good will*. Good will is supposed to be made up of a varied group of so-called intangibles, such as trade names, etc., but essentially it represents the public confidence in the officers and executives of the corporation, and is therefore an income producing factor in the business. If an efficient officer dies, that good will shrinks because the earning capacity of the corporation is diminished. Good will is

recognized by the Treasury Department and its value is determined by capitalizing the earnings over and above a fixed percentage on the physical assets and obsolescence of good will is in some cases permitted. There is no reason why the value of an officer cannot be estimated and carried on the books under its name as well as under the term "good will." If the officer dies, he is wiped off the slate as an asset and the insurance proceeds go to physical capital, and the company's balance sheet theoretically remains the same.

We do not say that accounts are kept in that manner, but the fact that they are not has no bearing on the question of whether or not the officer is a valuable asset so that his death may not be compensated for without the compensation being income. Carrying an officer on the books as an asset would seem no more absurd to a bookkeeper of fifty years ago than many of the other assets he would find on a modern balance sheet. Accounting as a "science" was born with the present day income tax laws and its treatment of accounts lacks any persuasive value for the reason that facts are too often concealed beneath sugar-coated nomenclature, and the basic principles to be deducted from a given state of facts is lost sight of in the desire to fit every concept into a perfect system. Lawyers long ago learned that systems must be altered to fit facts.

For instance the government argues that a loss could not be claimed because of the death of an officer. We might go further and state that so far as we know, the loss of a physical asset, so

far as the Constitution is concerned could not be claimed as a deduction from *income*. This has never been decided because Congress has always provided for the deduction of losses from current *income*. The point is that whether losses can or cannot be deducted, *compensation* received for a *loss* is not income. The thing that can be taxed under the constitutional grant is *income* but it must *be* income to be subject to the tax. If there is simply the substitution of one thing of value for another of equal value, there *is* no income.

Having shown that the proceeds of insurance are compensation for a loss, and not income derived from capital, there remains only one objection raised by the government to be answered and that is: Can the life of an officer be valued so that the extent of the loss can be calculated? This objection offers no more difficulty than the valuation of anything else. What is the value of a piece of machinery or a share of stock? The value is simply and purely a matter of judgment and estimation. If the machinery or stock has a "market" value, the judgment of the community interested in the buying and selling of such commodities is taken as fixing the value. If there is no market value, the earning capacity of the asset over a period of years is capitalized and its "value" approximated. If that cannot be done, experts are called in and give their opinions and finally someone exercises his judgment and gives his opinion as to the value and if his judgment is final, the value is fixed.

If a piece of machinery is being insured, its value is fixed in that way. If the machinery is

destroyed, that value is returned to the owner. And at this point to meet another observation of the government, the amount returned is not the income which the machine would have earned over a period of years, paid all in one year, and therefore taxable as income, but is the substitution of an equivalent of value as capital, from which income in the future will be derived, either from a new machine purchased with the money or the use of the money as capital in any way.

We see no reason why the value of an officer of a corporation cannot be arrived at just as well as anything else can be valued. It is true that being a part of an organization his earning capacity may be interwoven with that of the other members of the organization, but his value can be approximated just as well as the value of a machine performing one operation in a series of processes.

In fact, the valuation placed on the life of an officer is likely to be a conservative estimate because the company must pay premiums commensurate with the value placed on the man, and in a case like the present, where the company faces a long period of paying such premiums based on the likelihood of the officer living for a long time, the self-interest of the corporation would be persuasive of a reasonable estimate being placed on the officer's life. In the present case, Biddle was a healthy and vigorous young man of thirty-seven at the time he was insured and except for the occurrence of the influenza epidemic in the following year, would have been likely to live many years according to the ordinary expectancy of life. The interest of the company

then in conserving its resources is a good indication of the fact that Biddle's value as an asset was arrived at with care. The government has not undertaken to refute the fact that he was as valuable to the company as $100,000 of money capital. A valuation of this kind is stripped of all sentimentality and stands for what the man is worth to the company as an income-producing factor and has no reference to the esteem and affection with which his friends and family regard him. To the company he had the same kind of value as a machine or a sum of money; to his family and friends he was priceless, of course, because of attributes which bore no relation to his ability to earn income for the company, or in other words, his value as a capital asset. He had been identified with the company for years and for all that is known, expected to remain with the company; he was its president, and the leading personality of the organization and his value was as easy of estimation as any other value.

We therefore reaffirm that this company made no profit on premiums, that what it received in life insurance proceeds was compensation for a loss and not income and that the value of that loss was and could be estimated. So that these insurance proceeds do not answer the constitutional definition of income.

Besides the definition of income which this court has evolved, there is another test of whether or not a given thing is income. First, what was the meaning of income at the time of the adoption of this amendment? It has been shown that Congress never undertook to tax the

proceeds of life insurance prior to the time of the adoption of the Sixteenth Amendment; and by a Treasury construction, long acquiesced in by Congress, life insurance proceeds were not considered as taxable income. That being the known state of the law and its construction when Congress proposed the amendment and the states ratified it, the meaning of the word "income" in the Constitutional Amendment must be construed as not including the proceeds of insurance.

> *Gibbons* v. *Ogden*, 9 Wheat 1.
> *Eisner* v. *Macomber*, 252 U. S. 189.

Furthermore, the meaning which words have when used in the Constitution is not confined to technical definition, but the popular conception of such words must be taken into consideration. In *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509-519, Mr. Justice Clarke said:

> "In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the *commonly understood* meaning of the term *which must have been in the minds of the people* when they adopted the Sixteenth Amendment to the Constitution." (Italics ours.)

Considering that to hold that the proceeds of a life insurance policy paid to a corporation amount to income, is to hold also that the proceeds of all life insurance policies are income in the constitutional sense, and perhaps further

still, that the proceeds of fire, marine, and casualty insurance, are income, we firmly believe that such a conception was far from the "commonly understood" meaning of the word income at the time of the adoption of the Sixteenth Amendment. To carry this point, we are perhaps reduced to the necessity of resorting to *argumentem ad hominem* but it seems to us clear that the average citizen did not look upon the payment of premiums to an insurance company as the investment of capital; rather, he looked upon them as an expense. He did not take out insurance on his life to provide a profit for his wife; what he wanted to do was to provide as large a fund as possible to sustain her and that was the wife's idea if she insured her husband. So far as he had any accurate conception of capital and income, he wanted to provide something in the nature of capital to take his place at his death. Insurance agents approached only the most gullible with the assertion that insurance was an "investment" because it could be demonstrated that money would earn more in other fields. Insurance agents soon came to "sell protection" and to support their puffing with the thought that the prospect would not miss the premiums whereas he would not set aside any savings as a fund for the protection of his dependents. In fact, insurance would never have succeeded on the basis of offering an investment in the form of profits. It was the constantly recurring example of a widow being supplied with a fund upon the death of her husband with which to sustain herself and to ward off catastrophe which taught men the

value of life insurance. The whole thought was and is that a capital fund is put at the disposal of the beneficiary. And the attitude of the rich more than that of the poor clinches the point. A man of means took out insurance to a point which would insure a safe amount of capital for his wife and dependents and with that he stopped. The remainder of his fortune he put in investments. Insurance was protection; investments which might produce income either to himself or heirs was a risk for the very reason that he was seeking income. When men invest money, they are looking for a return of income to themselves; when they take out insurance, they seek to provide a fund for the use of a beneficiary to whom they are bound by consanguinity, affection or affinity.

And what is said as to insurance taken out because of natural affection applies *a fortiori* to insurance taken out as a protection against the death of an officer of a corporation, where a monetary loss will ensue, or in the case of marine, fire or casualty insurance, where the loss of a physical asset must be compensated for.

We therefore say confidently that the proceeds of life insurance were not thought of as income by the people generally at the time of the adoption of the Sixteenth Amendment. And we are confident that corporations would not have paid out such proceeds as dividends on the theory that the corporation had made extraordinary profits, but would have preserved them as capital. The notion of such proceeds being income was not in the people's minds.

CONCLUSION.

In concluding, it must not be lost sight of that in this case the Government exacted as a tax approximately 86% of the life insurance proceeds which the company received—$84,737.95 tax on the proceeds of $97,947.28. This, of course, included a penalty of $4,468.50 which was assessed for not reporting the proceeds as taxable income, notwithstanding the company notified the Government of the receipt of these proceeds by a notation attached to its return.

The exaction of such a tax is incompatible with any notion of the usefulness and purposes of life insurance. The very size of the tax argues better than words that either the Treasury Department is wrong in its construction of the act, or, if it is right, that the act is unconstitutional so far as it attempts to tax such proceeds as income.

Considering, too, that if Robert Biddle, 2nd, had died after the passage of this act, and had paid the premiums on these policies (Reg. 63, Art. 27, 29, 30), that the proceeds would have been taxed, in addition to the income tax, an estate tax, the unconstitutionality of this tax becomes even more apparent. Double taxation is always to be avoided, and such a tax would approach dangerously near confiscation. *Brushaber v. Union Pacific Railroad Company*, 240 U. S. 1. The test of Constitutionality is what may be done and not what is done under a given act. *Moreland v. U. S.*, 258 U. S. 433-441.

Furthermore, to say that life insurance proceeds are part of the assets of a decedent's estate passing at his death and are at the same time "income" to the beneficiary (although

Congress itself has exempted the value of any devise, bequest or gift from income) is to attain the zenith of inconsistency.

We respectfully submit that life insurance proceeds are not income to the beneficiary, because they are neither taxed by the Revenue Act of 1918, nor are they income *derived* from capital; they are nothing more than an indemnity for a loss and cannot be taxed constitutionally.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1923.

1C

No. 447.

THE UNITED STATES, Appellant,

vs.

THE SUPPLEE-BIDDLE HARDWARE COMPANY.

APPEAL FROM THE COURT OF CLAIMS.

APPENDIX TO APPELLEE'S BRIEF.

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APPENDIX.

Treasury Rulings, Regulations and Pertinent Parts of Acts Referred to in Appellant's Brief and Appellee's Brief.

I.

Ruling Under Act of 1867.

Ruling on Act of March 2, 1867, 14 Stats. 471, 487 (see appellee's brief, page 15).

Internal Revenue Record (N. Y.); issue of April 6, 1867, Volume V, No. 14, Whole No. 118, page 109.

Instructions, Income, Gifts of Money.

Gifts of money, when clearly not in the nature of payment for services rendered, or other valuable consideration, are not liable to taxation as income. Amounts received on life insurance policies and damages recovered in actions of tort are exempt from income tax.

II.

Act of 1913.

Section B. (1) Act of October 3, 1913, 38 Stats. 166, 181, c. 16.

B. (1) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation, or personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever including the income from but not the value of property acquired by gift, bequest, devise, or descent:

B. (2) Provided, That the proceeds of life insurance policies paid upon the death of the person insured

B. (3) or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income.

*   *   *   *   *   *   *

G. (*a*) (1) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships; but if organized, authorized, or existing under the laws of any foreign country, then upon the amount of net income accruing from business transacted and capital invested within the United States during such year.

Treasury Decision 2090, *December* 14, 1914.

PART I.

Rulings in Relation to Personal Income Tax

*   *   *   *   *   *   *

Insurance Premium.—* * * Premiums paid on life insurance by the insured do not constitute allowable deductions under the income-tax law.

Premiums paid on life insurance taken out by a partnership upon the lives of individual members of such partnership constitute allowable deductions in ascertaining the net earnings of the partnership. However, when such policies

mature, or upon the death of the insured partner, the amount received as life insurance should be included in the gross income of the partnership.

* * * * * * *

Part II.

Rulings in Relation to Corporation Income Tax.

Life Insurance in Favor of Corporations.—In cases wherein corporations pay premiums on insurance policies insuring, in favor of the corporations, the lives of officers or others, such premiums may be allowably deducted from the gross income of the corporations paying the same.

In all such cases the proceeds of the policies when paid at maturity or upon death of the insured shall be returned by the corporation as income for the year in which such proceeds were received.

Treasury Decision 2519.

(Vol. 19, page 150.)

Treasury Department,
Office of Commissioner of Internal Revenue,
Washington, D. C., *August* 30, 1917.

To collectors of internal revenue:

T. D. 2090, in so far as it authorizes corporations to deduct from gross income the annual premiums paid on policies insuring the lives of officers or employees in favor of such corporations, is hereby modified to the extent that instead of the corporations carrying such insurance being permitted to deduct from gross income of

the year in which paid the amount of the annual premium payments, they will hereafter be permitted to deduct from the gross proceeds, when received, of any policies of which the corporations are the beneficiaries the entire amount of the premiums paid during the term of the policies, less any premium payments which, under the former ruling, have been deducted from gross income in any return of annual net income, and the net proceeds of the policies thus ascertained will be returned as taxable income of the year in which received.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:
W. G. McADOO,
Secretary of the Treasury.

* * * * * * *

Act of September 8, 1916.

Estate Tax Provisions, c. 463, § 202.

The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated:

(*a*) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate.

* * * * * * *

Regulations 37, *Issued October* 10, 1916.

Art. IV. The gross estate of a decedent, as defined in section 202, includes:

(1) The entire estate of every kind, real, personal, and mixed, tangible and intangible property, coming into the hands of executors or administrators, or such as would legally come into their charge if executors or administrators were appointed, and which property would be subject to charges against the estate, expenses of administration, and distribution to the heirs or legatees. This would include insurance, not payable directly to a beneficiary named in the insurance contract but passing as a part of the administered estate. It would include also the good will of claimant's business, if such good will possessed an actual monetary value. It includes, of course, real estate passing directly to heirs without the intervention of administrators.

* * * * * * *

Regulations 33, Issued January 2, 1918.

Art. 29, §196—Proceeds of life insurance policies payable to the estate of a decedent, when received by an executor or administrator, are, in the amount by which such proceeds exceed the premium or premiums paid by the decedent, income of the estate to be accounted for by the executor or administrator under the provisions of section 2 (*b*), act of September 8, 1916. This return is to be made on income-tax Form 1040 or 1040A.

* * * * * * *

Regulations 33, Art. 39, §196, as Amended by Treasury Decision 3190, July 1, 1921.

Reg. 33 (Rev.), Par. 196. Proceeds of life insurance policies payable to the estate of a decedent are not to be accounted for as income of the estate by the executor or ad-

ministrator under the provisions of section 2 (*b*), Act of September 8, 1916.

*   *   *   *   *   *   *

Reg. 33 (Rev.), Art. 236. Life insurance premiums not deductible.—Section 32 of the Act of September 8, 1916, specifically provides that premiums paid by corporations for insurance covering the lives of officers, employees, or those financially interested in the trade or business of such corporations, shall not be deducted from the gross income of the corporations paying the same. This provision is held to apply to all forms of life insurance, the premiums upon which the corporations may pay, whether or not the corporations are the beneficiaries of the insurance policies upon the death of the insured, and all rules and regulations in conflict with this article are hereby revoked.

Regulations Under 1918 *Act.*

Reg. 45, Art. 294.—Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. See articles 33 and 105-108. In either case the proceeds of such policies paid upon the death of the insured may be excluded from gross income if the beneficiary is an individual, but must be included in gross income if

the beneficiary is a corporation. See Section 213 (*b*) (1) and articles 72 and 541.

Reg. 45, Art. 541.—The gross income of a corporation for the purpose of the tax in general includes and excludes the same things as the gross income of an individual. It embraces not only the operating revenues, but also gains, profits, and income from all other sources, such as rentals, royalties, interest, dividends from stock in other corporations, and profits from the sale of capital assets. The proceeds of life insurance policies paid upon the death of the insured to a corporation beneficiary, less any premiums paid by the corporation and not deducted from gross income, are to be included in its gross income. See sections 213 and 215 of the statute and articles 31-88 and 294. But in the case of life and mutual marine insurance companies and of foreign corporations there are special provisions. See articles 548-550.

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Act of 1918, *Estate Tax Regulations* 37

Art. 32. Taxable insurance.—The statute provides for the inclusion in the gross estate of certain forms of insurance taken out by the decedent upon his own life. Two kinds of insurance are taxable: (*a*) all insurance payable to the estate; (*b*) insurance payable to individual beneficiaries to the extent that it exceeds $40,000. The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system. Insurance is deemed to be taken out by the decedent in all cases where he pays the premiums, either directly or indirectely, whether or not he makes the application. On the other hand, the

insurance should not be included in the gross estate, even though the application is made by the decedent, where the premiums are actually paid by some other person or corporation, and not out of funds belonging to, or advanced by, the decedent. Where the decedent takes out insurance in favor of another person or corporation, as collateral security for a loan or other accommodation, and the decedent, either directly or indirectly, pays the premiums thereon, the insurance must be considered in determining whether there is an excess over $40,000. Where the decedent assigns a policy, and retains no interest therein, and thereafter pays no part of the premiums, the insurance will not be considered in determining whether there is such a taxable excess.

Art. 33. Insurance in favor of the estate.—The provision requiring the inclusion in the gross estate of all insurance receivable by the executor, without any deduction, applies to policies made payable to the decedent's estate or his executor or administrator, and all insurance, regardless of the manner of execution, which is in fact receivable by the estate, or which must be used to pay charges against the estate or the expenses of administration. This provision includes insurance taken out to provide funds to meet the estate tax, state inheritance taxes, or any other legal charge upon the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of the charge.

Art. 34. Insurance receivable by other beneficiaries.—The estate is entitled to only one exemption of $40,000 upon insurance payable to beneficiaries other than the executor. For example, if the decedent left life insurance payable to three persons in amounts of $10,000, $40,000, and $50,000 (total

$100,000), the amount of $60,000 should be returned for taxation, which is the excess of the sum of the three policies over the exempted amount. The word "beneficiary," as used in reference to the $40,000 exemption, means a person entitled to the actual enjoyment of the insurance money.

Art. 35. Effective date of insurance provisions.—Insurance receivable by the executor must be included in the gross estate of all decedents who died after September 8, 1916. Insurance payable to beneficiaries other than the executor, however, need not be included in the gross estate of decedents who died before February 25, 1919, the effective date of the Revenue Act of 1918, unless the insurance was originally payable to the estate, and was transferred by the decedent to specific beneficiaries in contemplation of death.

Art. 36. Valuation of insurance.—The amount to be returned in the case of any policy is the amount actually receivable by the executor or beneficiary. In cases where the proceeds of a policy are made payable to the beneficiary in the form of an annuity for life or for a term of years, the present worth of the annuity at the time of death should be included in the gross estate. For the method of computing the value of such an annuity, see Article 20. Where the insurance contract gives an option to receive a fixed sum of money in lieu of an annuity, this sum, if accepted, represents the value of the insurance for the purpose of the tax. If such sum is not accepted the value of the annuity is to be included in the gross estate. Where there is more than one option, and nine of them is convertible, the value of the insurance should be determined in accordance with the option actually exercised.

(Reg. 62, Art. 27, 28, 29, 30 and 31 under the Act of 1921,

are substantially the same as the above, with slight modifications in wording.)

This case is before the Committee on appeal from the decision of the Income Tax Unit holding that the M Company of which A was the sole owner of the stock, is liable for income and excess profits taxes on the proceeds of a life insurance policy received in 1918.

Rulings of Committee on Appeals and Review
Ruling 50-20-1245
C.R.R. 335
3 Cumulative Bulletin p. 244 (1920)

The facts appear to be that A, now deceased, was the sole owner of the capital stock of the M Company, a holding company which was organized to hold title to certain property belonging to A, and that during his lifetime he took out a life insurance policy on his life and made it payable to the M Company upon his death, but reserved the right to change at any time the beneficiary named in the policy. He paid all the premiums on the policy, the corporation had no investment in said policy, and upon his death the proceeds thereof were paid to the company.

The corporation contends that the proceeds of the policy in question do not constitute taxable income in the hands of the corporation, because such proceeds represent a gift to the corporation and are in no event gross income within the meaning of that term as used in section 213 (*a*) of the Revenue Act of 1918.

The only question presented in this appeal may be stated as follows: Do the proceeds of an insurance policy paid under the circumstances stated above upon the death of the insured to a corporate beneficiary constitute taxable income to the recipient under the provisions of the Revenue Act of 1918? This being purely a question of law, it was submitted to and passed upon by the Solicitor.

In order to pass upon the case it is necessary to examine the provisions of law on the subject.

Section 233 (*a*) of the Revenue Act of 1918 provides:

That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, * * * with certain exceptions not here material.

Section 213 of the act provides:

That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(*a*) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * * but

(*b*) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured:

* * * * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income).

Article 294 of Regulations 45 as amended by T. D. 3019 deals with the question of premiums on business insurance and reads as follows:

Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. See articles 33 and 105 to 108. In either case the proceeds of such policies paid upon the death of the insured may be excluded from gross income if the beneficiary is an individual, but must be included in gross income if the beneficiary is a corporation. (See section 213 (*b*) 1 and articles 72 and 541.

Section 213 (*a*) defines gross income as including certain specified items and the "gains or profits and income derived from any source whatever." It was then provided in section 213 (*b*) 1 that the gross income should not include the proceeds of a life insurance policy paid to individual beneficiaries. This provision of law shows by implication that Congress considered that "gross income" would, without the specific exclusion of the proceeds of life insurance policies paid to individual beneficiaries, or to the estate of the insured, comprehend the proceeds of all life insurance policies.

From the foregoing it is reasonable to assume that Congress, by excluding from gross income the proceeds of life

insurance policies payable to an individual beneficiary or the estate of the insured, intended that such proceeds should be included in gross income when received by beneficiaries other than individuals or the estate of the insured. This view is supported by the legislative history of the act. Section 213 (*b*) 1 is identically the same as it appeared in the bill as drafted in the House. The Senate attempted to amend this section and it is stated in the Senate report on the Revenue Bill of 1918 (Report No. 617, 65th Congress, 3rd Session, page 6), that:

> The proceeds of life insurance policies paid upon the death of the insured are, under the House bill, exempt from taxation only when paid to individual beneficiaries, or to the estate of the insured. This limitation has been removed so as to place all beneficiaries, individual, corporate or otherwise, on the same footing.

The Senate later receded from this position and section 213 (*b*) 1 as drafted by the House, excluding from gross income the proceeds of life insurance policies only when paid to individual beneficiaries or to the estate of the insured, became the law.

After analyzing the arguments presented in this case and in view of the foregoing provisions of law and regulations, it is the opinion of the Committee that the proceeds of life insurance policies paid upon the death of the insured to a corporate beneficiary constitute a part of the gross income of such beneficiary for the purpose of the income and profits taxes imposed by the Revenue Act of 1918. Therefore, it is recommended that the action of the Income Tax Unit be affirmed.

It is also the opinion of the Committee that the receipt of the proceeds of the life insurance policy in question by this corporation creates an abnormal condition which affects the income of the corporation for the taxable year 1918. It is thought that the receipt of this income brings this corporation clearly within the provisions of section 327 (*d*) of the Revenue Act of 1918.

It is therefore recomended that the tax in this case be computed in accordance with the provisions of section 328 of the Act.

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